What Modern Antitrust Law Can and Cannot Teach about the First Sale Doctrine

Exhaustion and First Sale in IP Conference, Santa Clara University School of Law
November 5, 2010

Ariel Katz
Associate Professor
Director, Centre for Innovation Law and Policy
Faculty of Law
University of Toronto
Modern Antitrust Approach to Vertical Restraints

• Sherman Act, § 1:
  – “Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce ... is declared to be illegal.”

• But not all contracts are equal;
  – Horizontal
    • Suspicious
  – Vertical
    • Presumptively benign
Vertical Restraints

• Restrict what a buyer can do with purchased goods:
  – where can be resold;
  – to whom;
  – at what prices;
  – will buyer have to provide pre- or post-sale services, repairs, warranties, etc.

• Efficient (sometimes? Often?), e.g.:
  – Increase output through price discrimination
  – Encourage specific investment by local dealers

• Not illegal per se
Enforcing VRs

• No IP:
  – Enforced by contract and/or threat of termination
  – No recourse against 3rd parties

• With IP:
  – Potentially more effective enforcement of VR:
    • IP remedies > contractual remedies;
    • Can bind third parties (if IP not exhausted).
Hurried antitrust view of FSD

• FSD is a spoiler!
  – Limits the ability of enforcing efficient restraints;
  – Anachronistic antitrust implant within IP;
  – Should be abolished; if not
  – Workarounds should be valid, e.g.,
    • License restrictions, notice, contract.
Origins

• *Bobbs-Merrill Co. v. Straus*, 210 U.S. 339 (1908)
  – Conventional wisdom: a resale price maintenance (RPM) case - vertical;
  – Therefore, outdated.
  – Yes, but not only.
    • RPM was the means to enforce an industry-wide publishers and booksellers cartel;
    • Exclude “discounters”, (*Bobbs-Merrill Co. v. Straus*, 139 F. 155 (C.C.N.Y. 1905)).
First Antitrust Lesson

• Children! Beware of un-exhausted IP rights!

• Proposition 1
  – Un-exhausted IP rights can support cartels, and facilitate tacit collusion. They are more effective (dangerous) than contractual mechanisms.

• Relevant to many oligopolistic IP industries
  – Music, film, pharma, tech
  – (but actually to shampoos, watches, chocolate bars...)
  – Beware!
The Parallel Imports Flaw (national vs. intl. exhaustion debate)

• Common argument: “parallel trade should be banned (and intl. exhaustion rejected)” because:
  • It undermines cross-country price discrimination
    – therefore harms the poor countries;
  • Discourages local dealers from investing in, developing and servicing the market in target (high price) countries
    – Therefore harms consumers in high price markets;
  • Reduces IP appropriability and incentives to create
    – Therefore harms everybody.
Main Flaw

• Proves a trivial point (arbitrage can have some negative effects on distribution systems and appropriability);

• Explains very little;
  – But how seriously?
  – Should we worry about it?
  – Is legal intervention needed?
Even if arbitrage has negative effects

- Why ban only int'l. arbitrage, but not:
  - Inter-state/province
  - Inter-city
  - Inter-personal?
- Indeed, no-exhaustion should be the rule!
- **Proposition 2**
  - Antitrust insights do not actually prove that national exhaustion is superior to int'l. exhaustion.
2nd Flaw: Recognizing that Some Vertical Restrictions are Efficient Doesn’t Mean They Should be Part of the Property Bundle
Thinking seriously about VR

• Efficient VR:
  – Organizing efficient distribution systems when producers aren’t fully integrated into distribution and retail.
  – More generally,

• Proposition 3
  – When parties participate in a collaborative productive enterprise that requires specific investments and is prone to opportunism, various restrictions may be necessary for its success.
  – As a corollary, extending such restrictions to third parties (e.g., end users) is seldom necessary.
• **Proposition 4**
  
  — exhaustion should be the default rule, but parties should be permitted to workaround it in situations described in *Proposition 3*.
  
  — **Note:** emphasis on “in situations described in *Proposition 3*”, not on “permitted to workaround”
3rd flaw: “not taking Coase seriously”

• The ProCD move:
  – Property is property, contract is contract;
  – Copyright defines only default property entitlements, but parties can always deviate from them to realize gains from trade.
  – Exhaustion can be the default, but workarounds generally welcome.

• Children! Beware of the ProCD move!
Coasean logic in a non-Coasean world

The world of IP is non-Coasean

• If it were, there would be no need for IP rights:
  – Prospective authors/inventors and prospective users would contract *ex ante*;

• There would be no need for limited IP rights:
  – Users would demand permission and owners would be happy to grant them *ex ante* or *ex post*.

• The ProCD move inconsistent with these assumptions.
• **Proposition 5**
  
  – IP theory implies that exhaustion should be a sticky default rule.
  
  – Workarounds should be presumptively invalid, unless plaintiff persuades that:
    * Defendant participated in a collaborative productive enterprise that requires specific investments and is prone to opportunism, and
    * The workaround is necessary for its success (see Proposition 3).
Justifying exhaustion: IP Neutrality

• But what about: “exhaustion makes it more difficult for IP owners to fully appropriate the value of their works, and therefore reduces the incentives to create”?
  – Fits producer-centric innovation model;
  – Assumes that users are couch potatoes;
  – Ignores and taxes other sources of innovation:
    • User-innovation
    • Open-collaborative innovation
Justifying exhaustion: IP neutrality

• IP-neutrality:
  – Designing an IP system that, as far as possible, does not support one model of innovation at the expense of others.

• Exhaustion: crucial element of IP neutrality
  – Enables users to explore, adapt, modify, integrate and improve.
  – And if they can’t do that, it allows them to transfer possession to other users who might.

• Crucial for the “Progress of Science and the Useful Arts.”
The Peace and Love Bomb

Components

• Transgenic dove from Israel
• Patented genetically modified olive branches - for sale in Palestine
• John Lennon songs (on vinyl) – available in flea markets in the UK
• Windows 95 (never sold, only licensed)
• A 2G iPhone (incl. its 200+ patents) – for sale in Thailand
Conclusion

• What antitrust can teach us?
  – Beware of un-exhausted IP rights!
  – Allow workarounds when necessary for collaboration;

• What antitrust *cannot* teach us?
  – That national exhaustion is superior to intl. exhaustion;
  – That there should be no exhaustion; or
  – Workarounds are presumptively efficient;

• What IP-assumptions-taken-seriously teach us?
  – Exhaustion should be sticky.
  – That universal exhaustion is necessary for promoting the Progress of Science and the Useful Arts.